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No. 95-516

In the Supreme Court of the United States

OCTOBER TERM, 1995

JOHN R. SPICER, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the government's acceptance of petitioner's promise to pay $339,000 over time to settle the government's charges against him under the False Claims Act, 31 U.S.C. 3729, and for common law fraud transformed what was a nondischargeable "debt * * * for money [or] property * * * obtained by * * * fraud" under Section 523(a)(2)(A) of the Bankruptcy Code, 11 U.S.C. 523(a)(2)(A), into an ordinary contract debt that could be discharged fully through petitioner's later bankruptcy.

2. Whether the court of appeals erred in finding that petitioner's fraudulent misrepresentations were a proximate cause of the government's losses.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	5
Conclusion	12

TABLE OF AUTHORITIES

Cases:

Bobofchak, In re, 101 B.R. 465 (Bankr. E.D. Va. 1989)	7
Brown v. *Felsen*, 442 U.S. 127 (1979)	5, 7, 8, 9, 10
Daley, In re, 776 F.2d 834 (9th Cir. 1985), cert. denied, 476 U.S. 1159 (1986)	8, 10
Gondor v. *Kelley*, 372 F.2d 94 (9th Cir. 1967)	3-4
Greenberg v. *Schools*, 711 F.2d 152 (11th Cir. 1983)	4, 6, 7
Grogan v. *Gardner*, 498 U.S. 279 (1991)	6
Guerrerio, In re, 143 B.R. 605 (Bankr. S.D.N.Y. 1992)	7
Kovacs, In re, 42 B.R. 1 (Bankr. D. Mass. 1982)	7
Maryland Casualty Co. v. *Cushing*, 171 F.2d 257 (7th Cir. 1948)	3
Pavelka, In re, 79 B.R. 228 (Bankr. E.D. Pa. 1987)	7
Rush, In re, 33 B.R. 97 (Bankr. D. Me. 1983)	7
Turner, In re, 179 B.R. 273 (Bankr. D. Colo. 1995)	7
United States v. *Hibbs*, 568 F.2d 347 (3d Cir. 1977)	11, 12
United States v. *Miller*, 645 F.2d 473 (5th Cir. 1981)	11, 12

Cases—Continued: Page

United States v. *Veneziale*, 268 F.2d 504 (3d Cir. 1959) 12
West, In re, 22 F.3d 775 (7th Cir. 1994) 3

Statutes:

Bankruptcy Act, § 17, 11 U.S.C. 35 (1976) 8
Bankruptcy Code, 11 U.S.C. 101 *et seq.*:
§ 523(a)(2), 11 U.S.C. 523(a)(2) 5, 8
§ 523(a)(2)(A), 11 U.S.C. 523(a)(2)(A) 3, 4, 6, 9, 11
False Claims Act, 31 U.S.C. 3729 *et seq.* 3, 11, 12
12 U.S.C. 1709(b) 2
18 U.S.C. 2314 2

Miscellaneous:

H.R. Rep. No. 1698, 57th Cong., 1st Sess. (1902) 9
Restatement (Second) of Judgments (1982) 8

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 26-46) is reported at 57 F.3d 1152. The opinion of the district court (Pet. App. 19-25) is unreported. The opinion of the bankruptcy court (Pet. App. 1-18) is reported at 155 B.R. 795.

JURISDICTION

The judgment of the court of appeals was entered on June 30, 1995. The petition for a writ of certiorari was filed on September 27, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The federal government, through the Federal Housing Administration (FHA), insures certain mortgages. 12 U.S.C. 1709(b). By statute and regulation, to be eligible for an FHA-insured mortgage, a home buyer must make a minimum down payment of at least three percent of the cost of the property. Pet. App. 2. The minimum down payment is required in order to demonstrate the buyer's financial qualifications and to ensure that the buyer has a personal financial stake in avoiding default and consequent loss to the federal government. *Id.* at 28 n.1, 40.

2. In October, 1989, petitioner pled guilty to one count of interstate transportation of money obtained by fraud, in violation of 18 U.S.C. 2314. In his factual proffer, petitioner, a real estate broker and investor, admitted that, from 1983 through 1984, he falsely represented to the Department of Housing and Urban Development (HUD) that the buyers in 81 of his sales transactions made down payments sufficient to qualify for FHA-insured mortgages. Petitioner admitted further that he intentionally overstated the buyers' down payments for the purpose of inducing HUD to provide mortgage insurance on the loans. The buyers of 43 of the 81 parcels eventually defaulted on their loans, resulting in losses of $1.8 million to the government. Petitioner was sentenced to four months' incarceration and was ordered to pay restitution to the government of $340,000, an amount equal to the total profits he had earned as a result of the 81 sales. Pet. App. 3, 27-28.

After his conviction, petitioner and the government executed a settlement agreement regarding the government's pending civil claims under the False

Claims Act, 31 U.S.C. 3729 *et seq.*, and for common law fraud. Pet. App. 28. The agreement recited the government's contention "that [petitioner] * * * caused the submission to HUD of * * * false applications for HUD mortgage insurance, and is liable for losses sustained in connection with claims for HUD mortgage insurance benefits submitted by [the] mortgage holders." *Id.* at 3. Petitioner did not concede liability, but he promised in the agreement to pay the government $339,000, plus interest at 8.5%, over a ten-year period in exchange for the government's release of all of its civil claims (except tax claims) against him. *Id.* at 28.[1]

3. On July 29, 1992, petitioner filed a voluntary petition under Chapter 7 of the Bankruptcy Code in the United States District Court for the District of Columbia, seeking, among other things, to discharge his debt to the federal government. The United States, in response, sought a determination that petitioner's debt for $339,000 was excepted from discharge under Section 523(a)(2)(A) of the Code, 11 U.S.C. 523(a)(2)(A). Pet. App. 29. The bankruptcy court granted the government's motion for summary judgment, *id.* at 1-18, and its judgment was affirmed on appeal by the district court, *id.* at 19-25.

4. The court of appeals affirmed. Pet. App. 26-46. The court rejected the approach followed by the Seventh Circuit in *Maryland Casualty Co.* v. *Cushing*, 171 F.2d 257 (1948), and *In re West*, 22 F.3d 775 (1994), and the Ninth Circuit in *Gondor* v. *Kelley*, 372 F.2d 94 (1967) (per curiam), that a settlement

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[1] Once the settlement became final, the district court deleted the restitution order from petitioner's criminal sentence. Pet. App. 28.

agreement effects a "novation" through which a nondischargeable debt for "money [or] property * * * obtained by * * * fraud," 11 U.S.C. 523(a)(2)(A), is replaced by an ordinary contractual obligation that is dischargeable in bankruptcy. Pet. App. 29-30. In the court's view, that approach—"under which, through the alchemy of a settlement agreement, a fraudulent debtor may transform himself into a nonfraudulent one"—is not compelled by the text of Section 523(a)(2)(A) and "improperly elevates legal form over substance." Pet. App. 30.

The court sided instead with the weight of recent authority, agreeing with *Greenberg* v. *Schools*, 711 F.2d 152, 156 (11th Cir. 1983), that, where a debtor seeks to discharge an amount due under a settlement, the relevant "debt" is the obligation that gave rise to the settlement. See Pet. App. 30-31 (citing cases). Looking behind the settlement agreement to the underlying nature of the claim "would not hinder the overall scheme of the Bankruptcy Code of giving the *honest* debtor a fresh start," and would better effectuate Congress's intention, through Section 523(a)(2)(A) "to discourage fraudulent conduct and to ensure that relief intended for honest debtors does not inure to the benefit of the dishonest." Pet. App. 32 (emphasis added).

The court also rejected petitioner's claim that his fraudulent misrepresentations were not the proximate cause of the government's losses on the defaulted mortgages. Pet. App. 35-43. The court agreed with petitioner that proof of fraud "requires more than mere 'but-for' causation," *id.* at 35-36, but it concluded that, since petitioner's misrepresentations implicated both the buyers' financial wherewithal and their incentives to avoid default, the

government's losses from the buyers' eventual defaults derived foreseeably from petitioner's conduct, *id.* at 40.

ARGUMENT

1. The court of appeals' holding that an obligation owed under a settlement agreement is nondischargeable if the debt underlying the settlement was incurred by fraud is in square conflict with the Seventh Circuit's approach in *West* and *Maryland Casualty*, and with the Ninth Circuit's decision in *Kelley*. Moreover, the issue is one of considerable importance. We do not believe, however, that certiorari is warranted at this time.

The court of appeals' decision in this case was correct, and its interpretation of Section 523(a)(2) is consistent with this Court's interpretation of that Section's Bankruptcy Act precursor in *Brown* v. *Felsen*, 442 U.S. 127 (1979). The court of appeals' holding is, moreover, consistent with the clear weight of recent authority. The Ninth Circuit has not revisited the issue presented in this case since *Felsen*, and while *Kelley* remains on the books, its precedential value is open to question—leaving the Seventh Circuit as the only jurisdiction that indisputably disagrees with the holding below.

a. Petitioner concedes that he intentionally misled the government when he falsely stated that the buyers had made legally sufficient down payments. He does not dispute the lower courts' findings that HUD reasonably relied on his misrepresentations and that the government suffered losses of approximately $1.8 million when the buyers defaulted on their mortgage obligations. Petitioner argues (Pet. 6-9), however, that the debt that he owes to the

government under the settlement agreement is dischargeable, because the government's fraud claim was extinguished by virtue of the release. That argument is incorrect.

Section 523(a)(2)(A) excepts from discharge "*any* debt * * * for money [or] property * * * obtained by * * * fraud." 11 U.S.C. 523(a)(2)(A) (emphasis added). Petitioner in this case obtained property—FHA mortgage insurance—by fraud. The debt arising from the settlement agreement is an obligation to repay part of the value of that fraudulently obtained property. Nothing in the language of the settlement agreement in this case, or in the general nature of settlement, suggests that the government gave up its right to demonstrate in a subsequent bankruptcy proceeding that petitioner's debt "was derived from [his] alleged fraudulent conduct." *Greenberg*, 711 F.2d at 156.

Maintaining the focus of the inquiry on the underlying nature of the claim is consistent with Congress's desire to "limit[] the opportunity for a completely unencumbered new beginning to the 'honest but unfortunate debtor.'" See *Grogan* v. *Gardner*, 498 U.S. 279, 286-287 (1991). That interest would not be served by permitting an obligation that originated in the debtor's fraud to be discharged simply because the debtor entered into a settlement agreement. As the court of appeals observed, "[s]ettlement makes the dishonest debtor no more honest, and no more entitled to the relief Congress intended to reserve for the honest debtor." Pet. App. 32.

b. The approach adopted by the court below is consistent with that taken by the Eleventh Circuit in

Greenberg,[2] and with the decisions of bankruptcy courts in five other circuits that have followed *Greenberg*. See *In re Turner*, 179 B.R. 273, 276-277 (Bankr. D. Colo. 1995); *In re Guerrerio*, 143 B.R. 605, 611 (Bankr. S.D.N.Y. 1992); *In re Bobofchak*, 101 B.R. 465, 467-468 (Bankr. E.D. Va. 1989); *In re Pavelka*, 79 B.R. 228, 232 (Bankr. E.D. Pa. 1987); *In re Rush*, 33 B.R. 97, 98 (Bankr. D. Me. 1983); *In re Kovacs*, 42 B.R. 1, 3 (Bankr. D. Mass. 1982).

The court of appeals' holding is also strongly supported by this Court's decision in *Brown* v. *Felsen*, *supra*. In that case, a creditor who had pursued both fraud and contract claims ultimately obtained a consent judgment that did not specify the grounds for the debtor's liability. When the debtor later filed for relief in bankruptcy, the creditor objected to discharge of the judgment debt. This Court held that, in resolving the dispute as to

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[2] Contrary to petitioner's claim (Pet. 6), the settlement agreement in *Greenberg* was construed as incorporating a complete release of the outstanding fraud claims, see Pet. App. 33, and the court of appeals in that case firmly rejected the argument that the release barred inquiry into the nature of those underlying claims:

> [A] debt which originates from the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement. The underlying debt was unquestionably the result of the debtor's fraud, not his breach of the settlement agreement. The fact that [the creditor's] claim never matured into a final judgment but was terminated by a settlement agreement should not be controlling. The Bankruptcy Court should inquire into the factual circumstances behind the settlement agreement to ascertain whether or not the debt incurred * * * was derived from the alleged fraudulent conduct * * *.

Greenberg, 711 F.2d at 156.

dischargeability, the bankruptcy court should look behind the judgment to the nature of the underlying debt.[3]

The factors that this Court found dispositive in *Felsen* apply with equal force in the present case. The debtor argued in *Felsen* that, because the creditor failed to pursue the fraud claim to final judgment or to obtain a stipulation expressly conceding fraud, the creditor was barred by res judicata from raising allegations of fraud in the later bankruptcy proceedings. 442 U.S. at 132. See also Restatement (Second) of Judgments § 18 cmt. a; *id.* §§ 17-18 (1982) (upon entry of judgment, underlying claims are extinguished through merger). Just as the release in this case left the government solely with an action to enforce the settlement agreement, the doctrine of res judicata left the creditor in *Felsen* solely with an action to enforce the judgment. This Court concluded in *Felsen*, however, that, for purposes of discharge, the key was not the type of legal action, but instead the "true nature of the [underlying] debt." 442 U.S. at 138. Absent prior judicial findings, the Court said, the bankruptcy court must resolve for itself whether the debtor "in fact committed the deceit." *Ibid.* See also *In re Daley*, 776 F.2d 834 (9th Cir. 1985), cert. denied, 476 U.S. 1159 (1986).

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[3] When *Felsen* was decided, discharge was governed by Section 17 of the Bankruptcy Act, 11 U.S.C. 35 (1976), a provision "substantially similar" to Section 523(a)(2) of the present Bankruptcy Code. *Felsen*, 442 U.S. at 129 n.1. "[N]o reason exists why the rationale of the [*Felsen*] decision should not be utilized in dealing with cases under Section 523(a)(2)." *In re Daley*, 776 F.2d 834, 836 n.5 (9th Cir. 1985), cert. denied, 476 U.S. 1159 (1986).

The Court found its interpretation consistent with Congress's desire to limit the "fresh start" to the "honest but unfortunate debtor." *Felsen*, 442 U.S. at 128. "By seeking discharge," the debtor "place[s] the rectitude of his prior dealings squarely in issue," because the bankruptcy court "may not [afford] a discharge [to a debtor who] has committed certain crimes or offenses," including, under Section 523(a)(2)(A), obtaining money or property through fraud. 442 U.S. at 128-129.

The Court found further support in the legislative history of the bankruptcy statutes. See *Felsen*, 442 U.S. at 138. It noted that the 1898 Bankruptcy Act originally excepted from discharge only "judgments" sounding in fraud. *Ibid.* That provision was amended in 1903 through the substitution of "liabilities" for "judgments," so as "to exclude beyond peradventure certain liabilities growing out of offenses against good morals." *Ibid.* (quoting H.R. Rep. No. 1698, 57th Cong., 1st Sess. 3, 6 (1902)). Congress's desire to reach all liabilities incurred through fraud suggested that "all debts arising out of [fraudulent] conduct * * * should be excepted from discharge," regardless of whether the original debt had been transformed by a "conscientious creditor," prior to bankruptcy, into some other form, such as a consent judgment. *Ibid.*

Finally, this Court rejected as impracticable the suggestion that, to preserve his objection to discharge in the event of the debtor's future bankruptcy, a creditor must in all pre-bankruptcy lawsuits litigate to final judgment the nature of the underlying debt. That alternative would force courts to decide questions of fraud "at a stage when they are not directly at issue and neither party has a full incentive to litigate them." *Felsen*, 442 U.S. at 134. As this

Court noted, "[i]t makes little sense * * * to resolve a * * * dischargeability question according to whether or not the parties * * * waived their right to engage in hypothetical litigation." *Id.* at 137. As this Court recognized, it is eminently reasonable for a creditor to seek a non-fraud remedy in order to resolve a matter expeditiously. *Id.* at 137 n.8.

c. Although the Ninth Circuit's holding in *Kelley* is at odds with the decision below, it is unclear whether *Kelley* remains good law. More recently, in *Daley*, creditors who had stipulated to a dismissal of their fraud claims after being granted summary judgment on their contract claims sought to prevent discharge of the contract judgment in bankruptcy. Looking to the guidance provided by this Court in *Felsen*, a panel of the Ninth Circuit held that the creditors were not foreclosed by res judicata or collateral estoppel, 776 F.2d at 837-838, and it directed the bankruptcy court to "consider all relevant evidence bearing on the nature of the debt" underlying the judgment, *id.* at 839. The panel in *Daley* did not advert to the Ninth Circuit's earlier decision in *Kelley*, and it would be difficult to reconcile the two cases. It would not seem to make a difference for purposes of discharge in bankruptcy whether a fraud claim was extinguished by a dismissal with prejudice (as in *Daley*) or by a release (as here). *Daley* therefore casts considerable doubt on *Kelley's* continuing vitality.

That leaves the Seventh Circuit, which in *West* recently reaffirmed its holding in *Maryland Casualty* and specifically criticized the analysis of the bankruptcy court in the present case. In our view, the position taken by the Seventh Circuit, based on that Circuit's pre-*Felsen* precedent, does not

require certiorari review of the correct decision in this case, which is in line with the clear direction of lower court authority. The issue is important, however, and review may well be indicated if a more significant split develops among the courts of appeals.

2. Petitioner argues (Pet. 9-11), in addition, that the court of appeals erred in concluding that the record supported the bankruptcy court's finding that petitioner's misrepresentations proximately caused the government's losses. The court correctly applied the law to the particular facts of this case, however, and its decision in this case does not conflict with the decision of any other court of appeals.

The court of appeals recognized that more than mere "but-for" causation is required to prove fraud for purposes of Section 523(a)(2)(A), Pet. App. 35-36, but it correctly found that petitioner's misrepresentations concerning the amount of the buyers' down payments—information that went to the buyers' financial wherewithal and their incentives to avoid default—proximately caused the losses suffered by the government in honoring its mortgage insurance obligations, *id.* at 42.

Contrary to petitioner's claim (Pet. 10-11), the court's ruling in that regard was not inconsistent with the holdings in *United States* v. *Hibbs*, 568 F.2d 347 (3d Cir. 1977), or *United States* v. *Miller*, 645 F.2d 473 (5th Cir. 1981). *Hibbs* involved a suit against a real estate broker under the False Claims Act based on his submission of false certifications concerning the properties' compliance with FHA requirements for plumbing, heating, and electricity. In that case, the court held that the false statements were not proximately related to the government's insurance losses, because those losses were caused by the

buyers' defaults, not by any deficiencies in the homes' plumbing, heating or electrical systems. 568 F.2d at 351. The court specifically distinguished *United States* v. *Veneziale*, 268 F.2d 504 (3d Cir. 1959), a guaranteed loan case in which the false representation arguably had some relevance to the creditworthiness of the borrower. See *Hibbs*, 568 F.2d at 352. *Miller* affirmatively supports the decision below. In that case, the court of appeals reversed the district court's dismissal of a False Claims Act complaint that alleged misrepresentations concerning the purchasers' creditworthiness, net worth, and down payments. 645 F.2d at 476 & n.3.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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